Corporate Governance as a Factor for Investment Decision Making on CEE Equity Markets

Julija BISTROVA, Natalja LACE
Faculty of Engineering Economics and Management, Riga Technical University
6 Kalnciema Str., Riga, LV-1048, Latvia

and

Manuela TVARONAVICIENE
Faculty of Business Management, Vilnius Gediminas Technical University
Saulėtekio al. 11, Vilnius, LT–10223, Lithuania

ABSTRACT

In the developed stock markets the corporate governance aspect is crucial in the stock portfolio selection process for investor seeking to achieve shareholder value sustainability. In the emerging markets the importance of the corporate governance role just starts to be realized by the investors and by the corporate managers.

The present research, looking at the stock performance leaders and laggards, analyzes whether the corporate governance system matters to achieve long-term shareholder value within the Central and Eastern European stock markets universe. Corporate governance quality was assessed and compared among the out- and underperformers. Additionally, the financial results plausibility and the ownership structure were considered.

The obtained results provide the proof that the corporate governance does matter as the market outperformers have above average corporate governance quality and provide trustworthy financial results more often than the underperforming companies.

Keywords: Corporate governance, Ownership structure, Earnings quality, stock performance, CEE equity markets

1. INTRODUCTION

The topic of the corporate governance is being thoroughly discussed withtin the Central and Eastern Europe (CEE) stock markets, and obviously the companies succeed in their efforts bringing their corporate governance systems to the world-class quality standards, complying with the best practice principles (Bistrova, 2014). But the question is about the pay-off and the trade-off between the investments in the corporate governance system establishment and the decent economic and market performance.

It is a well-known fact that the „evil" stock indices significantly beat the stock indices comprised of only SRI complying companies (Lobe, Walkshäusl, 2008). However, there are also the studies proving that it is worth investing in the companies sticking to the high level of CSR as they deliver market-neutral or above market average performance (Arx & Ziegler, 2008; Wang, 2011).

However, being SRI compliant and having excellent management team and supervisory board organization is just one side of the corporate governance system. The other and the most influential stock performance wise is the ethical side of the earnings management as well as the ownership structure particularly in the regions, where the concentrated shareholding is widely spread phenomenon.

Central and Eastern European companies quite often have major owner in the capital structure, who is also being very active in the routine company management (Lace, Bistrova & Kozlovkis, 2013). Besides, the creative accounting practices tend to emerge on the corporate landscape of CEE countries quite often (Bistrova, 2014). All these factors undoubtedly affect the performance of the CEE investors' stock portfolios.

Moreover, low level of corporate transparency and low media coverage typical for the emerging markets could lead to the non-normal return distribution (Connover, 2011). Therefore, the majority of investors in CEE companies appreciate very good information disclosure, which could positively influence the stock performance of the company in the long-term.

Thus, the aim of the present study is to find out to what extent the above mentioned corporate governance system elements affect the stock performance.

The study's principal hypothesis is the following:

The companies having good corporate governance quality and high earnings plausibility are able to deliver higher shareholder value in the long-term.

Additionally, the authors checked to what extent the shareholder structure influences stock performance. For these purposes the ownership classisifaction was developed offering to distinguish major owners by the type (the aim of the shareholding) and by the location. Besides, the authors verified whether high ownership concentration structure adds more value when investing in the companies.

2. LITERATURE REVIEW

Content analysis on the shareholder value sustainability factors mentioned in the scientific articles proves that the corporate governance factor gains importance (Bistrova, 2014). It enjoys more attention than it used to both from the corporates and from the active investors' side, who often see the necessity to integrate this factor into the portfolio selection process.

A number of studies conducted on the developed markets state that the corporate governance has strong influence on the stock market returns. Gompers, Ishii and Metrick (2003) constructed "Governance Index", which covered the assessment of shareholders' rights at 1,500 companies in 1990s. Based on the index, they have modeled the portfolio strategy that would consider 'long' companies with strongest rights (lowest decile) and 'short' companies with weakest rights (highest decile). As a result, the investor could earn 8.5% outperformance. Similar study was done by Drobetz et al. (2003) in Germany showing the monthly difference in performance of well and poorly governed firms of 1.73%.

The significant correlation of such factors as CG index, CEO-Chairman separation and independence of board members with stock performance was found by Bhagat and Bolton (2008). But they did not find any evidence to prove the assumption that the quality of CG is a proxy for future stock performance. The findings of their study also show that given the low quality of corporate governance of a certain entity and given its poor performance, there is a high probability of management turnover.

Positive correlation between the firm value and the quality of corporate governance in case of 300 largest European companies (FTSE Eurotop 300) has been indicated by Dutch scientists Bauer, Guenster, Otten (2004). But when adjusting for country difference, the relationship is weakening.

The contrary situation was discovered in Japan by Aman and Nguyen (2007), who discovered that poorly governed firms outperform well-governed firms. The results were statistically insignificant, but the study clearly showed that significantly higher risk is attributed to the poorly governed firms.

Some research was conducted considering separate factors, which determine the quality of corporate governance. Strong relationship was identified between equity performance and board independence (Hermalin & Weisbach, 1998, 2003; Bhagat & Black, 2002), stock ownership of board members (Bhagat et al., 1999), separation of the CEO and Chairman positions (Brickley et al., 1997).

The story in the emerging markets is a bit different: due to ownership structure, which is often concentrated, the companies have rather low motivation to disclose information to outsiders. The need in the minority shareholders is obviously less, compared to the situation in the developed markets. The regulations regarding corporate governance are less strict than they are in the developed stock markets. In most cases these are just recommendations imposed by the local stock exchanges. Anyway, the question of the influence of corporate governance becomes more topical. In case of favourable outcome (positive correlation with stock returns), the obtained results proved by the empirical research can be used to persuade the companies to stick to the best practice.

The available related literature provides the evidence of outperformance of the well-governed companies also in the emerging markets. Roy Kouwenberg (2006) states that the corporate governance matters with regard to Thai public companies: stock return of the best 20% companies according to the CG score in the period 2003-2005 was by 19% p.a. better than the stock return of the weakest 20% companies.

The Indian market represented as NIFTY 50 was studied by Samontaray (2010), who found significant relationship between the share price and such independent variable as EPS, sales, net fixed assets as well as corporate governance factors.

Another important consituent of the corporate governance system is the ethical management, which in parts can be detected by the earnings quality analysis. A number of scientists proved that (Dechow & Dichev, 2001; Mahedy, 2005; Sloan, 1996) the accruals as a measure of earnings plausibility negatively affect equity performance. The US scientists Sloan (1996) and Houge and Loughran (2000) empirically proved that the companies having high accruals perform worse than the companies that do not have any accruals. The analysts of an asset management company Bernstein (Mahedy, 2005) proved that accruals are a powerful tool, which can be used for predicting future earnings and share performance of the company.

3. RESEARCH DESIGN

The expanded notion of the corporate governance includes not only the relation to the system of the governing bodies, but it also covers the ethical approach to the company management as well as the ownership structure.

Therefore, the author focused on the key dimensions of the corporate governance in its expanded notion: quality of the management team and supervisory board organization, quality of the earnings management and the ownership structure specifics. These corporate governance elements were evaluated separately for the market leaders (outperformers) and the market laggards (underperformers) in terms of the total shareholder return. These groups of companies were compared, according to the following criteria:

- Overall rating of corporate governance quality is based on the model developed by Bistrova and Lace in 2011, which includes the assessment of the board of directors, management team, quality of the investor relations and the information disclosure;
- Earnings quality assessment was based on the evaluation of the accruals level relative to the net operating assets;
- Owership specifics was evaluated based on the major shareholder type (family, government, financial, strategic ownersor free float), on the location of the major holder (local or foreign) and on the ownership concentration level (dispersed or concentrated). The holder was classified as a major holder if it owns more than 10% of the total capital, while the ownership structure was considered to be concentrated if a major holder owns 25% of the capital or more.

The research sample is limited by the quoted CEE companies, which were the components of the local stock exchanges main lists in the financial year 2010. The static sample composition was considered in order to avoid the survivorship bias. The sample list includes 117 companies, the components of the main indices of the CEE stock exchanges: 15 companies traded in the Czech Republic (PX Index), 10 companies traded in Croatia (CROBEX), 12 companies traded in Hungary (BUX), 20 companies traded in Poland (WIG), 10 companies traded in Romania (BET), 7 companies traded in Slovakia (SAX), 6 companies traded in Slovenia (SBI TOP), 13 companies traded in Estonia (OMX BBGI), 5 companies traded in Latvia (OMX BBGI), 19 companies traded in Lithuania (OMX BBGI). These are the largest companies traded in the CEE countries with relatively good liquidity and above average market capitalization compared to other companies traded on the CEE market. One company, Czech electricity company CEZ, has dual listing on Prague Stock Exchange and on Warsaw Stock Exchange, so it was considered only once leading to the overall sample of 116 companies.

The selection of the companies, which managed to deliver sustainable out- or underperformance was made on the annual basis, classifying the company if it managed to beat the equally-weighted performance of the market as the winning company (outperformer), and as the laggard (underperformer) if it delivered TSR below the market return. The timeline of the analysis included 8 annual periods: from 2005 till 2012, which also covered the financial crisis becoming an important milestone for the CEE equity market development. The company was classified as a sustainable outperformer if it delivered above average result for 5 years and more; and it was classified as a sustainable underperformer if it delivered below average result for 5 years and more. The analysis shows that the companies underperforming the market 5 times and more (48 firms) significantly exceed the number of the companies, outperforming the market for 5 years and more (15 firms). Therefore, it was decided to consider also the expanded sample of the outperformers, i.e. the companies delivering alpha for 4 years and more (41 firm).

4. RESEARCH RESULTS

A. Corporate Governance Quality Evaluation

Corporate governance analysis, made according to the proposed corporate governance model states that the companies, which outperformed for 5 periods and more, are better managed and are more transparent than the average company, while the underperformers have an opposite situation, but the difference, however, is not very substantial (Figure 1).

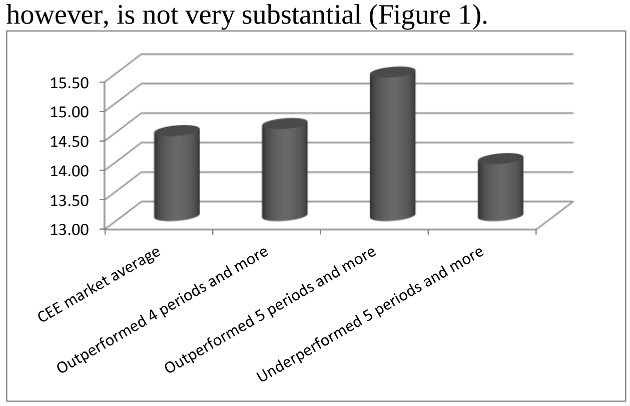

Figure 1 Average corporate governance quality levels of out- and underperformers.

Further deeper analysis of the difference of corporate governance quality between the sustainable out- and underperformers proves that the major discrepancy between these two groups of the companies is seen in the quality of the information disclosure and the level of investor relations (Table 1). In the conditions of the limited information availability in the emerging markets investors obviously value more the quality of the information provided by the listed companies.

Table 1

Average corporate governance levels of sustainable out and underperformers

	Super-visory Board	Mana-gement Team	Investor Rela-tions	Informa-tion Disclosure
CEE market average	4.91	2.91	1.84	3.90
Outperformed 4 periods and more	4.90	2.89	1.86	4.11
Outperformed 5 periods and more	5.18	2.98	2.09	4.59
Underperfor-med 5 periods and more	4.97	2.85	1.69	3.65

The quality of the management team organization is not very important aiming to achieve sustainable outperformance. Although the leading companies (outperformed for 5 periods and more) have the highest rating for the supervisory board, also the lagging companies can boast of well-established structures of the board of directors, earning higher rating than the market in general and higher than the expanded sample of the outperformers.

B. Earnings Quality Assessment

Accrual level as a proxy of the earnings quality, which allows defining plausible earnings forecast and, therefore, market expectations, was tested with the two year lag to the equity performance. Two year lag turned to be the optimal for the accruals to have an influence on the stock performance. Obviously data manipulation is negatively reflected in the financial results during the period of more than one year (Bistrova, 2014).

The chart (Figure 2) demonstrates that basically in each year the outperformers had lower accrual level, calculated according to the cash flow method, than the companies, which are classified as consistent underperformers.

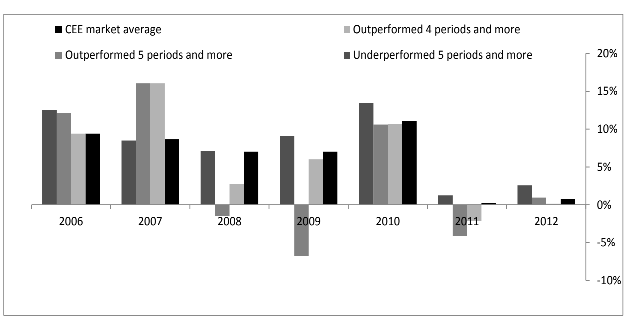

Figure 2 Median accruals level (based on C/F calculation methodology) of sustainable out- and underperformers.

The exception is 2007, when the investors obviously didn't pay attention to the financial state of the companies, which delivered high alpha. The statement was proved also in case of the profitability (many outperformers had lower than average profitability in 2007). Besides, the accruals level of outperformers and underperformers was calculated according to the data extracted primarily from the corporate balance sheets. The results obtained from this method (proposed by Richardson & Tuna), which assumes net operating assets being in the centre, are not perfectly comparable with the results obtained from the calculations according the cash flow method, when the cash flows from operations and investments are the key elements. The difference between the leading and the lagging companies is not obvious and the logical pattern of the relationship between the sustainable outperformance and very good earnings quality, indicating ethical corporate management, cannot be spotted.

C. Ownership Specifics

According to the data disclosed in Table 2, there is no particular bias to a certain ownership type as the percentage share in every group of the sustainable outperformers is not too much different from the general market. Still the concentrated outperformers sample (5 periods and more) is a bit more widely represented by the companies with the financial and strategic ownership, while a bit less by the companies with the governmental and family ownership. Obviously, CEE family-owned enterprises as opposed to their successful counterparts in the developed markets are not distinguished by the higher performance alpha and even some out of the researched sample filed for bankruptcy. So, the practice of the "built to last" family enterprises in the CEE financial field is not established yet.

Table 2

Sustainable out- and underperformers classified according to the ownership type

	Outperformed		Underper formed	CEE market average
	4 periods and more	5 periods and more	5 periods and more	
Share of total number of companies in the segment (%)				
Financial	20	23	20	19
Strategic	35	37	34	35
Government	20	15	20	20
Family	25	25	26	27
Share of total number of companies classified according to the particular shareholder type (%)				
Financial	25	13	28	100
Strategic	24	11	26	100
Government	24	8	26	100
Family	22	10	25	100

A third of the companies, which were classified as the underperformers, had foreign investors as major shareholders, while leading companies more often than the general market had local ownership as indicated in Table 3.

Table 3

Sustainable out and underperformers classified according to the ownership domicile

	Outperformed		Underper-formed	CEE market average
	4 periods and more	5 periods and more	5 periods and more	
Share of total number of companies in the segment (%)				
Local	69	69	63	68
Foreign	31	31	37	32
Share of total number of companies classified according to the particular shareholder type (%)				
Local	23	10	25	100
Foreign	22	9	32	100

Ownership concentration level obviously has more impact on the performance quality than the previous classifications of the ownership type. The companies, which were consistently underperforming the market, are more likely to have a dispersed ownership as proved by the results in Table 4. The companies delivering sustainable performance alpha in 92% of cases had concentrated shareholding structure, when an institutional or a private investor holds more than 25% of the total capital.

Table 4

Sustainable out- and underperformers classified according to the ownership concentration level

	Outperformed		Underper formed	CEE market average
	4 periods and more	5 periods and more	5 periods and more	
Share of total number of companies in the segment (%)				
Concentrated	83	92	63	75
Dispersed	17	8	37	25
Share of total number of companies classified according to the particular shareholder type (%)				
Concentrated	35	14	22	100
Dispersed	21	4	39	100

Possibly concentrated shareholding is the optimal ownership structure for the emerging market at its current development stage. The companies operate more efficiently if the business management decisions are influenced by one party, while the dispersed ownership does not provide the background for the successful enterprise development. It can occur due to the weak management team being not able to deliver sustainable TSR outperformance and, therefore, is the cause of high agency costs.

5. CONCLUSIONS

The obtained research results on the relationship between the corporate governance systems and equity performance robustness within the CEE stock markets partially prove the hypothesis, indicating that not every corporate governance aspect is crucial in search of the long-term performance alpha.

The study on the corporate governance environment discrepancies between the good and the bad companies in terms of the performance consists of the three parts: a) the general evaluation of the governance, where the primary focus was put on the management and supervisory board; b) the quality of earnings assessment, which alludes to a certain extent to the ethics of the management approach; c) the research on the ownership influence, considering the typology of the major owner, its location and the degree of the ownership concentration.

Though the leading companies can boast of the higher than average quality of the corporate governance in contrast to the lagging companies, the difference is not significant. Detailed analysis of the corporate governance elements evidences that the difference in the CG rating primarily is achieved by the very good information disclosure of the outperforming companies. This observation indicates high importance of the transparency of the company in the emerging European, where the media coverage of the listed companies is rather limited.

Earnings quality, which in the present research paper was evaluated based on the accruals level, has a potential to become an important factor to distinguish between the sustainable outperformers and the sustainable underperformers. The accruals calculated according to the cash flow method clearly are lower for the companies delivering sustainable outperformers basically through the whole observation period.

Ownership structure analysis evidences that the type of the major shareholder does not matter when selecting the stocks for the equity portfolio. The location of the major owner obviously has a more significant effect than the type of the shareholding. The most significant discrepancy between the market outperformers and market underperformers though appears when considering the shareholder structure concentration level. The investors are advised to give preference to the concentrated ownership, when selecting the companies for the “long” strategy equity portfolio in the emerging CEE equity market.

6. ACKNOWLEDGEMENTS

This study was conducted within the scope of the research „Enhancing Latvian Citizens’ Securitability through Development of the Financial Literacy” Nr. 394/2012.

7. REFERENCES

[1] U. Arx, A. Ziegler, (2008), **The Effect of CSR on Stock Performance: Net Evidence for the USA and Europe**. Working paper 08/85, CER-ETH, Center of Economic Research at ETH Zurich.

[2] J. Bistrova, N. Lace, (2011), Evaluation of Corporate Governance Influence on Stock Performance of CEE Companies. **The 15th World Multi-Conference on Systemics, Cybernetics and Informatics Proceedings**, Vol. 1, USA, Orlando, pp. 59-64.

[3] J. Bistrova, (2014), **Achieving Shareholder Value Sustainability on Central and Eastern European Equity Markets**. PhD Thesis. Riga: RTU, 203 p.

[4] H. Aman, P. Nguyen, (2007), Do Stock Prices Reflect The Corporate Governance Quality Of Japanese Firms? **Journal of The Japanese and International Economies**, Vol. 22, No. 4, pp. 647-662.

[5] R. Bauer, N. Gunster, R. Otten, (2004), Empirical Evidence on Corporate Governance in Europe. **Journal of Asset Management**, Vol. 5, No. 2, pp. 91-104.

[6] S. Bhagat, B. J. Bolton, (2008), Corporate Governance and Firm Performance. **Journal of Corporate Finance**, Vol.14 (Special Edition on Corporate Governance), pp. 257-273.

[7] S. Bhagat, D. Carey, Ch. Elson, (1999), Director ownership, corporate performance, and management turnover. **The Business Lawyer**, Vol. 54, pp. 1999.

[8] J. A. Brickley, J. L. Coles, G. Jarrell, (1997), Leadership structure: Separating the CEO and chairman of the board. **Journal of Corporate Finance**, Vol. 3, pp. 189-220.

[9] P. Dechow, I. Dichev, (2001), **The Quality of Accruals and Earnings: The Role of Accrual Estimation Error**. Stephen M. Ross School of Business/ Haas School of Business.

[10] W. Drobetz, A. Shillhofer, H. Zimmermann, (2003), Corporate governance and expected stock returns: Evidence from Germany. **European Financial Management**, Vol. 10, pp. 267–293.

[11] P. Gompers, J. Ishii, A. Metrick, (2003), Corporate governance and equity prices. **The Quarterly Journal of Economics**, Vol. 118, No. 1, pp. 107-155.

[12] B. Hermalin, M. Weisbach, (1998), Endogenously Chosen Boards of Directors and Their Monitoring of the CEO. **American Economic Review**, Vol. 88, No. 1, pp. 96-118.

[13] T. Houge, T. Loughran, (2000), Cash flow is king: Cognitive errors by investors. **Journal of Psychology and Financial Markets**, Vol. 2, No. 1, pp. 161-175.

[14] R. Kouwenberg, (2006), **Does Voluntary Corporate Governance Code Adoption Increase Firm Value in Emerging Markets? Evidence from Thailand.** Research paper, Mahidol University, College of Management.

[15] N. Lace, J. Bistrova, K. Kozlovskis, (2013), Ownership Type Influence on Dividend Payments in CEE Countries**. Business: Theory and Practice Journal**, Vol. 14, No. 3, pp. 259-266.

[16] S. Lobe, Ch. Walkshäusl, (2008), **Vice vs. Virtue Investing**. Retrieved on May 12, 2014 from http://www.fma.org/.

[17] J. Mahedy, (2005), **Taking Earnings Quality into Account: A Practitioner's Research into Balance-Sheet Accruals.** Retrieved on December 3, 2007 from http://www.alliancebernstein.com/.

[18] D. P. Samontaray, (2010), Impact of Corporate Governance on the Stock Prices of the Nifty 50 Broad Index Listed Companies. **International Research Journal of Finance and Economics**, Vol. 41, pp. 7-18.

[19] R. Sloan, (1996), Do stock prices fully reflect information in accruals and cash flows about future earnings? **Accounting Review**, Vol. 71, pp. 289-315.

[20] Y.G. Wang, (2011), Corporate Social Responsibility and Stock Performance—Evidence from Taiwan. **Modern Economy**, Vol. 2, No. 5, pp. 788-799.